THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number ~~264~~ 284 December 1996

World Recession 1997?

"It appears to me that one great cause of our difference in opinion on the subjects which we often discuss is that you have always in mind the immediate and temporary effects of particular changes, whereas I put these effects quite aside, and fix my whole attention on the long-term effects that will result from them."

Letter to Thomas Malthus
David Ricado, 1821

Signs of a slowing U.S. economy have triggered the customary knee-jerk rally on Wall Street, sending the Dow Jones Industrial Average to yet another record high. The impetus, of course, is the belief that sluggish growth will keep inflation – and the threat of Federal Reserve interest-rate hikes – at bay for the foreseeable future.

We agree with this assessment, but find little in it to celebrate. It is true: Inflation is dying, if not dead, in the major industrial countries – if by inflation one means a general rise in consumer and producer prices. Asset inflation, by contrast, remains alive and well, as the frothy state of the financial markets testifies. The markets certainly are correct not to fear a Fed tightening. Indeed, a rate cut, not a rate hike, is the U.S. central bank's next likely move.

But we part company with the bullish consensus when we ponder the long-term implications of this remarkable inflation performance. Where speculative enthusiasts perceive a millennial age of perpetual boom, we see a profound malaise in the formerly dynamic economies of the industrial world. The normal business cycle, with its periods of strong, investment-led growth followed by inflationary overheating, central-banking tightening and recession, has given way to a general stagnation, in which anemic growth and subdued inflation go hand in hand.

We believe this secular decline of growth can be traced to decades of fiscal and monetary excess that have promoted consumption, both public and private, at the expense of investment. The resulting maladjustments have crippled capital formation, permanently reducing the growth potential of the real economies. Accordingly, the major industrial countries – with the significant exception of the United States – now find themselves in the somewhat ironic position of having massive amounts of idle capacity, and chronic negative output gaps.

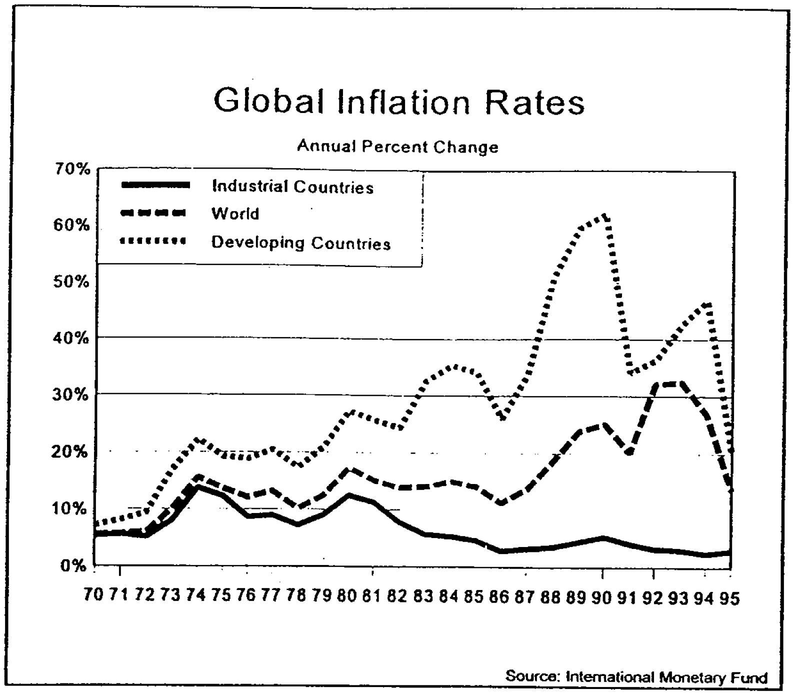
For speculators, the result has been a financial nirvana. Modest growth and inflation, bringing perpetually low interest rates, aptly have been described as the best of all possible worlds for stocks and bonds. But for stocks, the crucial ingredient in the formula is a continuation of the current global economic recovery. Yet that is precisely where our fears are greatest. In Japan and continental Europe, growth, always feeble, could falter at any moment. Even in the formerly booming economies of Southeast Asia, both export and import growth have collapsed. All eyes look to America to provide the world with a growth locomotive in 1997.

We see little hope for this scenario. U.S. consumers at last seem to have reached the limits of their five-year-long borrowing and spending binge. The retrenchment of U.S. consumer spending threatens to turn an economic slowdown into recession. The holiday shopping season, now upon us, should provide a litmus test of the danger.

If the United States stumbles into recession next year, the world is certain to follow. This, not the fading possibility of central-bank tightening, is the real risk facing the world's speculatively inflated equities markets.

THE RISE AND FALL OF INFLATION

The industrial countries now are enjoying their lowest inflation rates in more than thirty years, as seen in the chart here. While this decline has occurred across the entire world, it essentially has been most dramatic in the countries where inflation once had been most rampant.



What are we to make of this global decline in inflation? Is it a fluke – just a temporary deviation from the customary higher long-term path? Or, could it indeed be a definitive change in the trend, one that will create a new future norm? Is it possible that every single central bank in the world miraculously has been converted to fighting inflation?

Our short answer is that these low inflation rates are no fluke. They will remain with us for the foreseeable future, though with moderate fluctuations. That is the good news. The bad news is that the industrial countries also will remain mired in anemic growth, far below the trend of the dynamic 1950s and 1960s.

Actually, the sustained, high inflation rates of the 1970s and 1980s were without precedent in history. The long-term tendency in a capitalist economy is toward low inflation, if not price stability. Indeed, until World War I, the international experience was one of long-run price stability. Short periods of inflation – always war related – were followed by periods of deflation. Overall, prices fluctuated around a stationary trend. After World War I, various European countries suffered runaway inflation, also war related. But for other countries, including the United States and Britain, it was a period of price stability.

The sea change toward a sustained rise in inflation in the industrial countries started in the late 1960s. By 1970, average inflation had drifted to its highest level since the Korean War. While a downturn in economic activity in 1970-71 temporarily dampened global inflation, it surged again with the subsequent global recovery, which stoked an extraordinary boom in non-oil commodity prices. By 1973, the industrial countries had converged in a strong, synchronized boom. Combined with rampant commodity-price inflation, this triggered the first big hike in oil prices. But while the pressure on prices and wages escalated, many economies already were peaking.

Faced with surging prices at a time of weakening economies and rising unemployment, most governments and central banks initially failed to counter the inflationary shock created by the oil crisis. A widely held view at the time was that the huge oil price hike was not a monetary phenomenon, but rather a supply problem that ought to be accommodated by monetary policy. Before long, double-digit inflation rates were a common feature around the world. Inflation during that period reached peaks of 12% in the United States, 15% in France, 23% in Japan, and 25% in Britain and Italy.

Though monetary policy eventually was tightened, most countries still were left not only with much higher inflation rates than before, but also with a drastic ratcheting up of expectations about future inflation. Substantially higher inflation expectations and increased indexation of wages tended to lock in higher inflation rates. By the late 1970s, high inflation and correspondingly high interest rates had become a part of everyday life.

Only two central banks – the German Bundesbank and the Swiss National Bank – chose to rigorously counter the oil-price shock with an immediate, strict anti-inflationary monetary stance. Both countries ended up with far lower inflation rates than the rest of the world. This event, in particular, established the anti-inflation credibility of both central banks.

Yet, even German consumer prices recorded a cumulative rise of 61% in the 1970s and another 34% in the 1980s. But this compares with shocking increases of 102% and 62%, respectively, in the United States during the same periods. When judging this relative performance, we should remember that the United States had a long tradition of very low inflation and even price stability.

So much for the historical facts. They still leave us with the key questions: What have been the underlying causes of these changing inflation trends? What really fueled the synchronous, global burst of inflation in the 1970s and 1980s? Who, or what, has been suppressing inflation in the 1990s? And even more importantly, are those inflation-beating influences of a lasting nature?

LOW INFLATION THROUGH ABORTED GROWTH

Lacking another explanation, the consensus crowd likes to give the lion's share of the credit for the defeat of inflation to the wisdom of the central banks. Supposedly, the monetary authorities have learned to "fine tune" noninflationary growth. Baloney! There is no evidence of monetary fine tuning anywhere in the world. Over the past few years, central banks generally have kept their money and credit spigots wide open. Interest rates have been cut and then cut again, albeit with utterly disappointing effects on the real economies.

Instead of monetary constraint, there has been the utmost monetary looseness. Yet this laxness so far has failed to pull most of the industrial economies out of their lackluster economic performances. Japan has been only the most extreme example of this total failure of stimulative monetary policies. It is this general, global failure to promote growth – not monetary restraint – that has proved crucial to the suppression of inflation.

In other words, the global taming of inflation primarily is the upshot of the failure of loose and cheap money to spark stronger economic growth, not the product of some concerted anti-inflationary campaign by central banks around the world. The very idea is ludicrous.

In the last analysis, inflation has been tamed by something much more profound than central-bank stringency, namely the progressive diminution of the classic business cycle, with its associated periods of strong, investment-led economic growth. This distinction is of utmost importance. Although the U.S. economy has performed somewhat better than the rest of the industrialized world in the most recent business cycle, its rate of growth, too, has been far below the long-term average.

In fact, money and credit flows are vastly in excess of what the sluggish real economies need. In the 1970s, when this phenomenon first appeared, excess money kindled rampant inflation in the prices of goods, services and tangible assets, such as real estate and gold. But not this time. Instead of being channeled into the markets for goods and tangible assets, the excess money is piling up in the financial markets, forcing up bond and stock prices.

That money typically pours into the financial markets in times of economic weakness is nothing new. It regularly happens at the bottom of the business cycle, when monetary policy switches from tightness to ease. This, of course, is the stage most beloved by investors and speculators. In the past, however, this flood of money regularly would wind up back in the real economies, as excess liquidity was used to make loans or purchase new equity offerings aimed at increasing productive capacity. This, in turn, would fuel the next expansion, eventually bringing accelerating consumer- and producer-price inflation, and ultimately the next round of monetary tightening.

In this way, economies, interest rates and the financial markets all fluctuated in a distinct, predictable cyclical pattern. The key propelling mechanism was monetary policy, which alternated between easing and tightening. The periods of economic weakness and associated loose money invariably proved to be short-lived, and soon were followed by strong recoveries and monetary tightening.

But the protracted sluggishness of the industrial economies of today is no longer of a short-run, cyclical nature. Its root causes are structural, and therefore long-term. This persistent stagnation is the inevitable result of past policy excesses, which have resulted in a lasting impairment of economic growth. Paradoxically, chronic economic weakness has become a long-lasting guarantee of the loose monetary conditions that are stoking the spectacular boom in financial assets.

We recite the well-known characteristics of the normal business cycle in order to highlight the utter abnormality of the present situation. Despite ever looser money and ever lower interest rates, the customary, self-reinforcing cyclical upswing refuses to materialize, with the one, big exception of the United States.

THE AMERICAN EXCEPTION

The first, dramatic break in post-war global economic growth came in 1973, in the wake of the first oil-price shock. Abruptly, productivity growth plummeted, essentially making all countries more inflation prone. The decline was universal, although in Europe and Japan the slump started from a higher rate of productivity growth than in the United States. Sharply higher inflation rates and sharply lower economic growth became endemic, and the combination was widely labeled as "stagflation."

Only after Paul Volker took the helm at the Federal Reserve in 1979, and embarked on his rigorous anti-inflation campaign, did U.S. and global inflation begin to slow. In the second half of the 1980s, for the first time ever, strengthening economic growth coincided with a slow decline in inflation rates. This was widely labeled as "disinflation."

In the 1990s, the industrial countries confront yet another scenario. Consumer- and producer-price inflation has plunged to the low levels last seen in the healthy 1950s and 1960s. Even the most profligate former inflation reprobates have joined in the party. But this time the companion trend has been one of persistently anemic economic growth. With a single, important exception, the industrial countries are operating with chronic negative output gaps. That is to say, their domestic output is perpetually below potential output. The biggest gap afflicts the formerly high-growth Japanese economy.

The last time such output gaps proliferated on a global scale was during the world recession of 1980-82. Then, the U.S. economy had the largest gap. This time, however, America is the sole major exception to the industrial world's general sluggishness. Indeed, America is the one country in the world where domestic demand routinely exceeds domestic output. For some years now, this has been reflected in the chronically high U.S. trade and current-account deficits. In the last analysis, these deficits are the infallible signs of excessively inflated U.S. domestic demand.

LOW U.S. INFLATION IS BORROWED FROM ABROAD

There is a widespread perception in the markets that the Fed has done a masterful job of steering the U.S. economy along its capacity limits. Again, we must say: Baloney. In the absence of unutilized resources, real economic growth essentially is limited to potential growth, regardless of what a central bank does. What counts in this respect is the growth of domestic spending, not of domestic output as measured by real GDP. In the United States, spending has greatly exceeded potential GDP growth since 1983.

But in the given international environment of general economic sluggishness, foreign producers have easily and readily accommodate U.S. overspending by boosting their exports to the United States. They can do this because of their plentiful excess capacity. As a result, American excess spending inflates the U.S. trade deficit rather than internal consumer and producer prices. For the United States, this global glut is an absolutely crucial disinflationary safety valve.

In a closed economy, the effects of spending in excess of domestic output will show themselves entirely in rising prices. However, in an extremely open economy, like the United States, an overexpansion of domestic demand largely leaks abroad, bringing higher imports, lower exports, or both – in other words, a deteriorating trade balance. The larger amount of goods thus made available in the inflating country slow down or even prevent an internal rise in prices. When a country inflates its domestic demand, then, we should see this reflected *either* in consumer-price inflation or a rising trade deficit, or in some a combination of both. The latter alternative precisely fits the present pattern in the United States.

Not so long ago, all this used to be common knowledge to any first-year economics student. By the same token, external accounts used to feature prominently in the fears of investors and speculators. Even a modest deterioration in a country's trade balance tended to upset the financial markets.

These days, however, a massive U.S. trade deficit is treated as a matter of course. Since 1991, the annual U.S. merchandise-trade deficit has more than doubled, from $74 billion to presently around $190 billion at an annual rate. Overall, the United States in the past five years has run up a cumulative trade deficit of more than $700 billion. The annual deficit has averaged roughly 2% of GDP. If that appears relatively small, bear in mind that the entire U.S. manufacturing sector accounts for no more than 17% of GDP.

Without any question, this import deluge has played a crucial role in suppressing U.S. producer- and consumer-price inflation. In this light, praising the Fed for fine tuning noninflationary growth appears totally ludicrous. America's recent low inflation rates literally have been borrowed from abroad. What's more, a rising share of the capital inflows needed to make this possible is being provided by foreign central banks. To us, this hardly qualifies as an anti-inflation success story for the Fed.

One is tempted to say that the U.S. economy, with its permanent, large excess of domestic demand, has become the dumping ground for producers in the rest of the world. While this exchange helps the United States reduce inflation, it also helps the rest of the world increase output. Or, to put it differently: The U.S. economy has become the chief inflator of the world.

This state of affairs itself is a reflection of the structural afflictions hobbling growth in the industralized world. Certainly, if Japan's economy were more robust, the Bank of Japan would not feel compelled to purchase billions of dollars in U.S. Treasuries to prop up the dollar and the U.S. bond market. Nor would the BoJ's discount rate be at 0.5%, encouraging massive speculation in U.S. securities with borrowed yen. America's chronic overspending would no longer be sustainable, and economic growth would have to slow considerably, if not cease completely. In other words, America may be an exception to the industrial world's stagnation, but it is the exception that proves the rule.

EUROPE'S TRADE MIRACLE

The extreme opposite of the U.S. situation holds in Europe. As domestic demand growth has fallen increasingly short of potential output in recent years, the European Union has witnessed a dramatic reversal in its trade with the rest of the world. In 1991, the EU hit a record trade deficit with outside countries of $83 billion. Now, in 1996, after a steady, drastic improvement, a record surplus of more than $60 billion is in the offing -- a stunning $140 billion

swing. The main contributors to this trade reversal have been the former high-inflation and high-deficit countries: Britain, Italy and Spain.

Obviously, this abrupt move into surplus was absolutely crucial in pulling Europe out of its 1993 recession. By past standards, Europe's economic recovery has been unusually sluggish. Annual real GDP growth since the 1993 recession has averaged just 2.3%, making it the weakest cycle in the entire postwar period. But contrary to the general impression, the United States has fared little better – its annual growth rate during the cycle that started in 1992 has averaged just 2.5%.

What actually have differed most between the United States and Europe have been their relative employment and productivity performances. In the United States, with its abysmal productivity gains, even mediocre growth involves an employment boom. But in Europe, with its much higher productivity gains, the result of slow growth has been soaring unemployment. Since 1992, overall U.S. business-sector productivity has risen at an average annual rate of only 0.3%, versus 2% in Europe.

Real GDP Growth

	1961-73	1974-85	1986-90	1991	1992	1993	1994	1995	1996
Europe	4.7%	2.0%	3.3%	1.5%	1.0%	-0.6%	2.8%	2.5%	1.5%
United States	3.9%	2.3%	2.8%	-1.0%	2.7%	2.2%	3.5%	2.0%	2.3%
Japan	9.6%	3.6%	4.5%	4.3%	1.1%	-0.2%	0.5%	0.9%	2.9%

Source: The European Commission

SMALL BUT SIGNIFICANT DIFFERENCES

As the table above illustrates, the demise of dynamic growth is true for all the industrial countries. As previously mentioned, the sharp decline of inflation rates in the 1990s also has been a global phenomenon. Though the fall has been steepest in the developing countries, their current average rate of inflation still is a multiple of the the industrial-country average, which has fallen to a level last seen in the 1960s. Consequently, the remaining differences among the industrial economies are small, yet they still are significant.

Japan, of course, remains the star performer in terms of inflation. The pricking of the so-called "bubble economy" by the imposition of higher interest rates in 1989-90 caused asset prices (both real estate and equities) to collapse, plunging the economy into a recession from which it only now is barely recovering. The subsequent snail-like growth of the Japanese economy essentially has exerted a strong downward pressure on prices. Wholesale prices today actually are below their 1990 level, while consumer prices are just fractionally above their level of a year ago. But since Japan's inflation rate was rarely over 1% even during the booming bubble years, the change has been modest.

Europe is a very different case. It always had and still has substantially higher inflation than Japan, but on average, it has witnessed a dramatic decline. The main reason for this is the fact that all of the formerly notorious high-inflation countries, such as Italy and Spain, have enjoyed particularly steep declines in their inflation rates. This has sharply lowered the EU average, from 10.5% in the 1980s to 5.5% in 1991, and 2.6% presently. A number of countries, including Germany and France, have hit rates below 2%.

How does European inflation compare with American inflation? Actually, all through the postwar period the European average was considerably above the U.S. inflation rate. For years, the general fixation on the low-inflation DM bloc tended to obscure the fact that Europe had a number of chronic inflation countries, including, until relatively recently, France. No longer.

In fact, the country where inflation has slowed least in recent years definitely is the United States, where it continues to hover around 3%. Considering, as previously explained, that U.S. domestic spending is permanently in substantial excess of domestic output, this is hardly surprising. In the absence of the huge and rising inflow of imports, U.S. inflation certainly would be much higher than it is today. For good reasons, the United States is the only country in the world where the financial markets remain jittery about future inflation.

WILL INFLATION STAY LOW?

What about the future? Could inflation in the industrial countries truly be dead? Our short answer is yes, at least as regards inflation in producer and consumer prices. Yet there still are considerable differences in the underlying conditions among Japan, Europe and the United States. Of the three, Japan is by far the safest case. It is the low-inflation country *par excellence* by virtue of its record-high savings and investment ratios, which secure high productivity growth.

The one major country that requires at least some caveats from our general conclusion is, of course, the United States. Chronic credit inflation is likely to lead to a continuation of its equally chronic excess of domestic demand over domestic output. There always is the risk that the extra demand so generated eventually will begin to drive up the U.S. price level as well as the U.S. trade deficit. Yet, looking at the monstrous bubble that has been created in the U.S. markets, price deflation through debt and asset deflation still seems to us the greater long-run threat.

Having said that, we hasten to add that it is not trust in the wise policies of governments and central banks that comforts us about future inflation. What we see behind the prevailing disinflationary trend in the industrial economies – contrasting with rampant inflation in the financial markets – are mountains of debt and major maladjustments in the economic, financial and price-cost structures that determine the rate of private investment.

These growth-inhibiting debts and maladjustments are legacies of the monetary and fiscal excesses of the past, which everywhere boosted consumption at the expense of investment. To quote Ludwig von Mises, the doyen of the Austrian school of economics: “We have outlived the short run and have now to face the unpleasant long run.”

EUROSCLEROSIS

In the 1980s, when the world admired Reaganomics and Thatcherism as the supply-side wave of the future, “Eurosclerosis” was the derisive buzz word used to describe the perceived state of the continental European economies. In contrast to this euphoric consensus, we always had strong reservations about the two policies. In the long-term perspective, the crucial test of any economic policy is its impact on investment resources and investment incentives. But precisely by this measure, Reaganomics and Thatcherism have been disastrous for the United States and the United Kingdom. In both countries, the core problem has become the meager rate of capital formation.

The truth is that in terms of capital formation, continental Europe during the 1980s had policies that were far more supply-side oriented than in the United States. With the explicit objective of increasing the GDP share of investment, the average government deficit in the European Community was halved, from above 5% in 1983 to just 2.5% in 1988. Yet, Europe enjoyed higher economic growth than the United States and its strongest employment gains of the entire postwar period. Against this favorable backdrop, European governments confidently began work on the Maastricht Treaty, designed to complement the single European market with a single European currency.

Ironically, everything since then has gone dramatically wrong. Within just two or three years, all the prior fiscal consolidations were undone. While economic growth virtually collapsed, unemployment soared from 7.6% to 11%. The average EC gross government debt ratio rocketed from 55% to 74% in 1993, while the average budget deficit hit a new peak of 6.2% of GDP. Eurosclerosis, apparently, has come true at last. Despite desperate efforts to curb

deficits once again, in most countries progress has been too slow to fulfill the Maastricht criteria of deficits equal to no more than 3% of GDP in 1997.

EUROPE'S PROBLEM IS NOT INFLATION

After a disappointing past year, the European economy lately has picked up again. We express ourselves rather cautiously in this respect because while we, like the consensus crowd, discern an uptick, we see one without any cumulative or self-reinforcing qualities. These features depend fundamentally upon the vitality of the investment cycle, which fuels the famous multiplier process.

If this *is* a true economic recovery in Europe, we can only observe that the essential characteristic – a strong investment cycle – isn't part of it, save for a modest boomlet in inventory accumulation. Investment as well as consumer spending are just scraping along. Real disposable incomes are growing at less than half the rate of the late 1980s. A consumer-borrowing binge, as experienced in the United States since the early 1980s, is not yet fashionable in continental Europe.

To be sure, Europe has a colossal problem. But it definitely is neither inflation nor the threat of inflation. Indeed, it is just the opposite: continuous lackluster economic growth, bringing with it a persistent negative output gap and mass unemployment. This army of the jobless will only increase if there are not very soon radical reforms of the overextended welfare system and the extremely rigid labor markets. Though these underlying causes are well known to policymakers, they lack the will or the determination to undertake anything more than patchwork changes. This is particularly true for Germany and France.

While Europe's employment performance is an outright disaster, it should not be overlooked that a major culprit is the much higher rate of productivity growth there than in the United States. During the six-and-a-half years since 1989, cumulative U.S. real GDP growth of 13.9% – or 2.1% annually – has compared with U.S. employment growth of 10.7%, or 1.6% annually. During the same time, cumulative European real GDP growth of 10%, or 1.5% annually, has coincided with an absolute decline in employment of no less than 3%.

HOW WEAK THE EURO?

It is one of the great queries in the markets: Will the EU implement its common currency on schedule? And if so, will the Euro be weaker than the vanishing DM? Conventional wisdom holds that greater weakness is predestined.

Essentially, the question of the Euro's potential strength must be split into two parts. First, we must consider the likely internal rate of inflation in the common-currency zone. Secondly, we must judge the Euro's future exchange rate *vis-á-vis* the other major currencies, particularly the dollar. Possibly, the two rates might go in different directions.

As our long-time readers know well, we are radically opposed to the project of a common European currency, both for political and economic reasons. These will be the theme of a later letter. But high inflation in the Euro zone is not among our worries. Europe's overriding problem far into the future will remain lackluster growth and a relentless rise in unemployment, against a backdrop of high productivity growth. Together, these three conditions are conducive to lower, not higher, inflation.

What makes us so certain? In short, it is our cognition of the long-term corrosive effects of the existing, vastly excessive burden of government debt and spending on economic growth. Or, putting it rather succinctly: The ultimate effect of inflation is deflation.

How did we get to this sorry state? In short, through the government policies of the 1970s, which tried to push for higher growth with steadily increasing doses of fiscal and monetary stimulus. More than anything else, it was the apparent success of President Kennedy's fiscal package that whetted the appetite of Keynesian politicians and economists in this respect. Above all, after 1971, when President Nixon cut the link between the dollar and gold, the door was opened to runaway inflation through the monetization of limitless government spending and deficits.

So it happened. But it took a few years to turn the pattern of high growth and low inflation of the 1950s and 1960s into the opposite pattern of ever slower growth and ever higher inflation. The stronger economic growth that had been expected from the new policies never materialized. On the contrary, growth fell sharply, while inflation escalated. Keynes, in a poetical mood, once asserted that "credit expansion performs the miracle ... of turning stone into bread." In reality, it converted growth into stagflation.

The fact is that inflation rapidly lost any stimulative effects on the real economies. Why? Because precisely in line with the warnings of the Austrian school, escalating inflation led in the first place to overconsumption. Soaring government spending and borrowing depleted savings and crowded out productive investment. Simultaneously, the price distortions created by inflation led to massive malinvestments in the private sector. To again quote von Mises, the essence of credit inflation is not overinvestment but malinvestment and overconsumption.

The point to see about Europe's economies is that for far too long they have taken far too much of the Keynesian drug. The legacies are exorbitant levels of government debt and spending, and equally exorbitant tax rates. Together, these blights now pose an overwhelming impediment to long-term economic growth. On average, government spending in Europe now slightly exceeds 50% of GDP. To finance these spending excesses, governments have accumulated massive net interest bills that far exceed their current deficits, which equal about 5% of GDP. With their primary budget balances already in surplus, the European countries must drive them even further into surplus to bring their nominal deficits down to the 3% Maastricht target. This implies a formidable fiscal drag on already anemic economic growth. Truly, for Europe the long-run has arrived with a vengeance.

There is a widespread view that Europe's lackluster economic growth performance reflects overly tight money imposed by the Bundesbank. Correlated with this opinion is the notion that with the arrival of the common currency – if not before – Europe will embark on a massive reflation effort to boost economic growth, rekindling inflation.

We rigorously disagree. Europe's growth malaise has nothing to do with tight money. The all-too-striking proof is the boom in the financial markets. The primary factors retarding economic growth and inflation in Europe are the serious, structural maladjustments resulting from the prior monetary and fiscal excesses, on one hand, and higher productivity growth, on the other.

What, then, about the Euro's exchange rate relative to the dollar? The standard argument in favor of the dollar is that in terms of purchasing power it is drastically undervalued. This is true, but as we have pointed out before, what ultimately counts in the global currency markets is the relationship between supply and demand. This largely is determined by the trade and current accounts. The fundamental source of the dollar's long-term weakness is its endless oversupply resulting from the huge U.S. payments gap. By contrast, given the global economic environment, the EU's large trade surplus is likely to continue, if not grow. This implies a strong, not a weak Euro.

CLOUDS OVER THE WORLD ECONOMY

Turning again to the global economy, what really is in the cards? Where are the risks? As already explained, the risks definitely are not that a general overheating will cause rising inflation, as last happened in the late 1980s. In our view, the main future worry facing investors and policymakers will be disappointing economic growth, albeit with the comforting corollary of low inflation.

Until a few months ago, the chatter in the markets was all about a synchronized, global upswing, led by the U.S. economy. Instead, signs of economic weakness are multiplying around the world. Even in the Asian Tiger countries, economic growth has slipped badly. While U.S. technology stocks are skyrocketing, the technology industry in Asia is slumping. Most Asian bourses are trading below their 1993 highs. Tiger exports and imports, which rose 25%-to-30% last year, have slowed to near stagnation. The net effects, though, have been soaring trade and current-account deficits.

The whole world – not just Europe and Asia – is looking anxiously to the United States as the presumptive locomotive for world economic growth in 1997, as it has been for most of the 1990s. Considering that the annual U.S. merchandise-trade deficit already is approaching a record $200 billion, the idea is ludicrous, but nonetheless it is widely held. If the U.S. economy fails to live up to these expectations, the world economy will be in trouble.

In the last analysis, trying to forecast U.S. economic growth next year boils down to one question: Will the U.S. consumer-borrowing binge remain the major driver of overall demand growth? An affirmative answer to this question is the crucial assumption behind the consensus crowd's optimistic forecasts.

In our own economic model, such debt-financed overconsumption is the one of the structural maladjustments that predicate calamity. We simply find it difficult to believe that U.S. consumers will be able and willing to stretch their overleveraged balance sheets much further. In this regard, we find it quite significant that overall consumer borrowing growth peaked in February at a 12.4% annual rate, and that outstanding consumer debt contracted in September for the first time since May 1993.

THE MANIA CONTINUES ON WALL STREET

As a matter of fact, the emerging U.S. economic slowdown is precisely in line with our expectations and forecasts. What we misjudged, however, is the euphoria it would bring to the financial markets. Our long-term case against U.S. equities is the weak outlook for profit growth, which a sluggish economy can only weaken further. Earnings-per-share averages for the various stock indexes indeed have been flat for more than a year. The sole source of price appreciation during that time has been soaring valuations.

In our last letter, we explained how the preponderance of hedge funds, market-neutral strategies, financial engineering and massive derivatives use have led to a stock market that is ever more dislocated from economic reality. Well, it is going from wild to wilder.

In the Wall Street mantra, this is the best of all possible worlds for bonds and stocks. With slowing economic growth now keeping the Fed at bay, the other remaining potential trouble spot was eliminated on election day when the Republicans retained control of the House and Senate, preserving the political status quo.

Still, why this sudden, tremendous burst of stock buying? Nothing particularly sensational has happened. Again, we think the answer to this question lies more in market technicals than fundamentals. Reviewing past sharp fluctuations, we again would stress the fact that the ever-increasing use of derivatives, both for hedging and speculative purposes, now rules the markets. This is fostering aggressiveness and volatility.

It appears that during the early fall months a considerable number of hedging and speculative derivatives positions were structured to profit from, or protect against, any negative market reaction to the outcome of the U.S. elections. As the market instead soared on the election results, the unwinding of these unsuccessful positions added fuel to the advance. Given that this activity was predominately concentrated in the large-cap stocks and the major stock indexes, it is no surprise these spectacularly outperformed the broader market. The continued unwinding of unsuccessful bearish bets against the technology stocks only compounded the buying panic.

Much of the rest was simply jumping on the bandwagon. With many fund managers lagging the stock indexes so far this year, there has been a desperate flight to the largest stocks to improve year-end performance. Add to this stampeding herd the momentum players, whose simple quest is to buy the strongest gainers of the moment, and you have all the makings of a buying frenzy.

If there is any rational behavior at all behind the new tech boom on Wall Street, it is the belief that this sector is recovering from its summer doldrums. Third-quarter earnings reports from the semiconductor industry were overwhelmingly horrible. But only the few positive ones made the headlines. We can only wonder how the market can expect U.S. tech firms to flourish when their powerful Asian rivals are scrambling.

For example, while Wall Street focuses exclusively on positive earnings reports from the leading U.S. personal computer makers, we highlight the dismal reports about sales and prices, and the ramifications of the impending entrance of four Japanese behemoths – Sony, Toshiba, Fujitsu and Hitachi – into an already crowded field of PC producers. Their history of carving out market share through ruthless price cutting is legendary. As to sales, all the major U.S. computer retailers are reporting negative sales growth, leading to same-store results – and in many cases, even total sales – that are far below last year's levels.

We view all this as a replay of Wall Street's 1995 semiconductor craze, in which transient windfall profits were extrapolated to ridiculous extremes. Even as massive new production capacity came on stream, setting the stage for a 90% drop in memory prices, analysts continued their spirited support for the chip stocks, to the point of utterly ignoring the disastrous developments in the sector.

Today, in an even more speculative and unrealistic market, analysts can push stock prices up by doing nothing more than issuing declarations of nebulous optimism, raising their price targets and calling for higher multiples on earnings. As an example, we offer this somewhat incoherent comment from a recent high-profile recommendation for IBM, lately a market star performer: "The CFO (chief financial officer) made a number of important comments about the long-term, customers are demanding solutions, and that's where IBM is most competitive."

And what are the facts? So far in 1996, IBM stock has risen 72%. Yet year-over-year profits are slightly down, the usual perpetual "one-time" restructuring charges and other accounting gimmicks continue to obscure the true trend in operating earnings, and the company faces fierce competition throughout its business lines.

We have noted that Goldman Sach's superbull, Abby Joseph Cohen, recently reaffirmed her bullish stance, observing that the stock market's fundamentals still look healthy to her. Her verdict: long-lasting economic growth, albeit at a more moderate pace, nearly nonexistent inflation, lower interest rates and higher-quality earnings would continue to push the Dow higher still. We, on the other hand, can only wonder what is so exciting about an economy with 2-2.5% annual growth and 2.5-3% inflation. We also can only marvel at the market's ability to repeatedly discount the same half-baked assertions of allegedly good news. Is there no limit to valuations?

Contrary to our expectations, analysts and investors have ignored the flattening trend in profits and bid stocks still higher. Yet in its third-quarter GDP revisions, the Commerce Department revealed a decline in after-tax profits of $10.6 billion, or 2.6%, after a 0.2% decline in the second quarter. Unperturbed, analysts continue to issue glowing earnings forecasts. Bottom-up estimates for S&P 500 earnings call for almost a 15% increase next year!

CONCLUSIONS

Our 1997 scenario, on the other hand, includes a seriously faltering U.S. economy and still weaker profits. At some point next year, this will lead to a collision between what is good for bonds and what is bad for stocks. Investors will figure out that more pronounced economic sluggishness holds little promise for equities. In the "no

pricing power" environment of a recessionary 1997, earnings disappointments rapidly would accumulate, and they would hardly be assuaged by a decline in interest rates. Woe to the world economy, if that happens.

For us, the open question for 1997 is not whether the world economy will slow down, but by how much. Lurking behind the global economy's protracted sluggishness are mountains of dead-weight government and consumer debt, and deep-seated structural maladjustments that defy monetary solutions. The inevitable great recession of the 1990s has only been postponed, not cancelled.

Near term, everything hinges on U.S. consumers. If they choose to retrench, it will drive the U.S. economy into recession soon enough. Christmas sales will be the litmus test. In any case, we don't see real strength anywhere. Accordingly, we also see no material inflation on the horizon, least of all in Europe. Given this outlook, the logical investment choice, of course, is bonds, particularly medium- to long-term bonds.

Basically, this scenario of extended, if not worsening, global economic sluggishness is our long-held view. But up until now, we have refrained from recommending long-term bonds, partly because of the possible ramifications of EMU, and partly in recognition of the fact that all of the world's bond markets have been artificially pumped up by national and international carry-trade speculation, resulting in artificially low long-term interest rates.

As to EMU, our concerns about inflation have become rather more relaxed. All the talk about ugly fiscal fudging has distracted attention from the fact that inflation virtually has collapsed all across the EU. The reason is the profound new trend toward wage moderation. Europe's inflation always was more wage-driven than demand-driven. But wage demands have been firmly capped by the relentless rise in unemployment. In any case, we continue to doubt that EMU will be implemented on schedule. There are two major hurdles. First, for constitutional and political reasons, German politicians are compelled to insist on strict application of the Maastricht criteria. Secondly, lower-than-expected economic growth in 1997 will tear new holes in existing fiscal projections.

The down drift of the U.S. economy also speaks for bonds and against stocks. The more decisive question, however, is whether the unprecedented purchases of U.S. bonds by foreign central banks, and the massive carry-trade speculation in those bonds using cheap yen, will continue. Any significant reduction would badly damage U.S. bond prices. We assume these purchases will continue, yet the risks should be kept in mind. A strengthening of the Japanese economy, requiring rate hikes by the Bank of Japan, is the most obvious threat. But this is not in sight.

The greater long-term threat to the world economy remains the fundamental weakness of its key currency, the dollar. There is endless talk about dollar undervaluation. To us, what is incredible is that the combination of massive central bank purchases, huge capital inflows through the yen carry trade, an outperforming U.S. economy, and extraordinary bull markets in U.S. bonds and stocks has achieved little save to keep the dollar from collapsing.

THE RICHEBÄCHER LETTER

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